

CalPERS' 2005 MANAGEMENT LETTER RESPONSE

OTHER ACCOUNTING, ADMINISTRATIVE, AND OPERATING MATTERS California Public Employees' Retirement System Year Ended June 30, 2005

PUBLIC EMPLOYEES' RETIREMENT FUND

Item #1 – Reconciliation of CalPERS' Real Estate Contribution and Distribution Control Accounts

Observation—As of June 30, 2005, Investment Accounting was not able to provide detailed support to substantiate the balances in the Real Estate Contribution Control and Real Estate Distribution Control Accounts in CalPERS' general ledger. These two clearing accounts are intended to match cash transactions separately recorded by State Street and by the real estate partners. The sources of the amounts recorded in CalPERS' general ledger are State Street and the real estate partners' monthly financial statements. Balances in these accounts typically are the result of temporary timing differences between State Street real estate cash transactions and the monthly financial statements received from the individual real estate partners. As reconciliations are one of the most important components of internal controls, it is important that all activity in these accounts be specifically identified and reconciled on a timely basis.

Recommendation—Investment Accounting should establish a standard, repeatable, auditable, and meaningful process for capturing information in the real estate control accounts and reconciling the balances on a monthly basis. To accomplish this, it is necessary to identify all uncleared transactions in these account balances at the end of each accounting period. The sum of the identified uncleared transactions should equal the General Ledger account balance.

Management's Response

Fiscal Services concurs with the recommendation. Fiscal Services has established a team to develop a standard, repeatable and auditable process to reconcile and validate the real estate control accounts on a monthly basis.

Item #2 – Investment Accounting General Ledger Support

Observation—Fiscal Services does not use the investment accounting general ledger accounts to directly produce the annual financial statements. Rather, Investment Accounting performs a reconciliation from the general ledger to present the investment data for financial reporting purposes. This reconciliation is performed outside of Peoplesoft and contains significant reclassifying adjustments from the general ledger amounts. Additionally, as these adjustments are not posted in Peoplesoft, they are not reviewed by Investment Accounting management as part of the year-end closing and review process. As a result, the investment account balances in the general ledger do not agree to the amounts recorded in the annual financial statements.

Recommendation—CalPERS’ Peoplesoft general ledger system should directly produce and support the financial statements. The Investment Accounting general ledger should agree to the accounts and amounts used for financial reporting purposes. All reclassification entries should be approved by management and posted to the general ledger prior to generating the financial statements. Any reconciliations between the general ledger and the financial statements should be small in amount and subject to management review.

Management’s Response

Fiscal Services concurs with the finding. Fiscal Services will establish a team to review this issue and determine the most feasible approach to preparing our financial statements.

OTHER PENSION TRUST FUNDS—IRC 457 Plan

Item #3 – Reconciliation Process

Observation—During our 2005 audit, we identified significant differences between the recorded general ledger balances (i.e. transfers in, transfers out, and participant withdrawals) and the amounts provided by CalPERS’ program division. The amounts recorded in the general ledger are based on the State Street monthly statements, whereas the detailed schedules from the program division are generated by and agreed to information provided by CitiStreet, the fund’s record keeper. These differences were partially due to a one day delay in posting transactions between State Street and CitiStreet. For example, transactions occurring on the last day of the month are recorded by CitiStreet on that same day, however the transactions are not recorded by State Street until the subsequent day. As such, activity occurring on June 30, 2005, was not recorded by State Street until July 1, 2005, and thus was not reflected in the June 2005 general ledger.

We also noted that the difference between State Street and Citistreet was attributed to incomplete reconciliations that were not consistently prepared on a monthly basis. As the reconciliations were not completed, we identified keying mistakes and other errors that required corrections. These reconciliations had not been reviewed by management in accordance with CalPERS’ policy.

As a result of these findings, several audit adjustments were made to the IRC 457 Plan to true up the fund’s portfolio activity (including transfers in, transfers out, participant withdrawals, member contributions, investment income, other receivables, accrued liabilities and investments) and properly record the current year transactions as of June 30, 2005.

Recommendation—To ensure that errors are identified and reconciling items are resolved timely, reconciliations between State Street and CitiStreet should be performed monthly and completed on a timely basis. Any variances between State Street and Citistreet should be investigated, documented, and resolved. Additionally, recurring adjustments should be recorded to recognize the one day delay in posting activity between State Street and Citistreet . This reconciliation process should be assigned both a primary and secondary preparer and be reviewed and analyzed by management on a monthly basis.

Management’s Response

Fiscal Services concurs with the recommendation. Accounting discrepancies arose from the March 2005 establishment of two new State Street portfolios. Fiscal Services currently performs the following two reconciliations between 1) State Street vs. General Ledger, and 2) State Street vs. CitiStreet. Fiscal Services will timely complete as well as strengthen these monthly reconciliations to identify discrepancies

between the General Ledger, State Street, and CitiStreet. Both a primary and secondary staff person have been assigned to perform these reconciliations. Additionally, Fiscal Services will post a year-end accrual to recognize the one day delay in posting activity between State Street and CitiStreet.

PROPRIETARY FUNDS—CONTINGENCY RESERVE FUND

Item #4 – Application of Payments for Receivables From Public Agencies

Observation—Invoices are sent to public agencies on the 15th of the month prior to the coverage period (for example, invoices for June 2005 were sent on May 15). These invoices include premiums charges for both employers and employees. Amounts are due from the public agencies by the 10th of the coverage month. The payments received by Contingency Reserve Fund are applied against the outstanding receivable balance rather than to a specifically identified invoice. During each billing cycle, any remaining receivables are closed and then carried forward as an opening balance in the current month's billings. In addition, Contingency Reserve Fund does not have a receivables aging report to track the delinquencies and to analyze the age of an outstanding balance.

Recommendation—To ensure that payments are applied to the correct invoice billing cycle and that the aging of outstanding receivable balances are consistently monitored, Health Services should establish a standard method of applying payments to the specifically identified invoice, tracking unpaid balances, and recording an appropriate reserve if the balance is not collected timely. Aging reports should be generated on a periodic basis to monitor outstanding balances.

Management's Response

Fiscal Services concurs with the recommendation. An enterprise wide accounts receivable project (EMBARC) has identified the health premium billing and collection process as requiring improvement and will implement the recommendations of this report on July 1, 2006.

PROPRIETARY FUNDS—LONG TERM CARE FUND

Item #5 – Enhancements to Actuarial Valuation

Observation—The actuarial valuation for the Long-Term Care program was performed by United Health Actuarial Services for the 2004/2005 fiscal year. The previous valuations performed by Tillinghast included cash flow testing projections to assess the adequacy of the assets supporting the liabilities related to potential future new-money investment earnings scenarios. The current valuation does not include such an assessment.

Recommendation—CalPERS should include cash flow testing projections as part of the annual Long Term Care Fund actuarial valuation. Cash flow testing is required by state regulators for most LTC insurance programs and can be an integral part of the valuation process. Because LTC involves such long duration coverage, it is important that the assets be appropriately matched to the liabilities they are backing. Various future economic scenarios to project have been prescribed by the regulators, and certain criteria must be met in order to "pass" the cash flow tests. Failed tests can indicate the need to strengthen reserves.

While this does not directly impact the reasonableness of the current LTC program valuation from an audit perspective, we recommend that CalPERS reinstitute cash flow testing for valuations in future years as an additional assessment tool for determining the financial balance of the LTC program.

Management's Response

CalPERS' Health Benefits Branch and its actuary concur with the recommendation. We will review the prior actuarial work and develop a proposed approach that includes cash flow testing projections to assess the adequacy of the assets supporting the liabilities. CalPERS' actuary will develop a proposed approach for CalPERS' management to review in advance of the next valuation, and CalPERS' actuary will communicate the agreed-upon approach to Deloitte & Touche.

OTHER OBSERVATIONS AFFECTING ALL FUNDS

Item #6 – Recording of Transactions Outside the General Ledger

Observation—Certain of CalPERS' funds maintain monthly transaction activity in Excel spreadsheets. These spreadsheets are the sole support for the activity. CalPERS maintains an internal control structure over its Peoplesoft general ledger system. However, this internal control structure does not include Excel as end-user applications are not subject to normal information technology controls such as change controls, version controls or regular backups. Additionally, Excel is not supported by CalPERS' Information Technology Services Branch, reducing its reliability.

Recommendation—End-user applications (such as Excel) do not receive enterprise information technology support or use the same controls as the Peoplesoft financial accounting system. Peoplesoft is subject to important information system controls that is supported by CalPERS' IT department. Peoplesoft maintains sufficient capabilities to track all general ledger transactions and produce financial statements meeting CalPERS' requirements. Fiscal Services should avoid user-created spreadsheets to support the amounts in the financial statements as all activity should be posted directly to the Peoplesoft general ledger system.

Management's Response

Fiscal Services concurs with this recommendation. Fiscal Services will establish a team to review this issue and determine the most feasible approach to preparing our financial statements. A work plan will be developed which will include a specific date for completion.

Item #7 – Posting Journal Entries in Aggregate

Observation—Fiscal services and investment accounting post certain journal entries in the aggregate (such as on a monthly or quarterly basis). Posting journal entries in aggregate does not provide an adequate audit trail to investigate the underlying transactions or research historical activity. Additionally, posting journal entries in aggregate increases the probability of user mispostings or mistakes.

Recommendation—Journal entries should be separately posted for each identifiable accounting transaction. Appropriate support should be maintained for each posted activity. This will create an effective audit trail, facilitate research and investigation, and decrease the likelihood of user errors.

Management's Response

Fiscal Services concurs with this recommendation. Fiscal Services will develop a policy to require all journal entries to be properly supported, reviewed and approved by management so as to provide for an adequate audit trail.

Item #8 – GASB 40 Disclosures

Observation—The June 30, 2005, fiscal year-end was the first year CalPERS implemented the new GASB 40 disclosures for the Fund's investments. Fiscal Services used queries developed by State Street to assist in the disclosures. However, certain of the queries did not include the entire pool of investments held by CalPERS. For these queries, Fiscal Services had to estimate the disclosure information for investments excluded by the queries.

Recommendation—CalPERS should work with State Street to ensure that all applicable investment information and amounts are extracted for financial reporting purposes. Reports from State Street Bank should include all investments held by CalPERS. These reports should be reviewed by Fiscal Services and investment accounting management to determine the reasonableness and accuracy of the amounts.

Management's Response

Fiscal Services concurs with the finding. Fiscal Services has established a task force that includes a representative from State Street to understand the criteria for gathering the GASB 40 data and evaluating if this data meets the requirements of the standard. The results of this task force will be to meet the recommendation contained in this report or have adequate explanations of why certain securities are rightfully excluded. The June 30, 2006 financial statements will contain revised GASB 40 information as recommended.

Item #9 – Monitoring of Actuarial Assumptions

Observation—The Actuarial and Employer Services group recommended that the CalPERS Board adopt an employer rate stabilization policy to reduce the volatility of employer contribution rates. The recommended changes would be effective for the employer contribution rates for fiscal 2005-2006 for State and School plans and fiscal 2006-2007 for public agency plans.

The employer rate stabilization policy introduced the following three changes:

- Developing the Actuarial Value of Assets (AVA) by smoothing 15 years of asset gains and losses, with the result limited to within a corridor of 80%-120% of the market value. The old method uses three-year smoothing, with the result not to be outside a 90%-110% corridor. The corridor change was developed in relation to the change in the asset smoothing method. The use of this specific corridor is very common for pension plans

- Calculating the annual contribution amount with a rolling 30-year amortization of the gains and losses (“combine and offset”). The old method is based on a 10% amortization of the gains and losses
- Imposing a minimum employer contribution rate equal to the employer normal cost minus a 30-year amortization of surplus.

In terms of smoothing of assets, GASB 27 refers to Actuarial Standard of Practice Number 4 (ASOP 4), which in turn describes recommended standards for asset valuation and smoothing methods. The asset valuation method used by CalPERS produces substantially greater smoothing of asset values than is the norm for public pension plans. In the “Public Fund Survey for FY 2004 prepared by the National Association of State Retirement Administrators in September 2005, only 6% of 127 public pension plan surveyed used a smoothing method greater than 8 years (CalPERS was included in the 6%).

Recommendation—Due to the significant changes in the actuarial assumptions and methodologies, we recommend that AESD closely monitor the new approach to ensure that it provides reasonable results.

Management’s Response

Actuarial and Employer Services concurs with the recommendation and suggests adding this monitoring to the annual recap of public agency valuation results presented to the Board.

Item #10 – Information Security—Novell Administrators

Observation—Novell currently has 38 users with administrative access in the system with the ability to grant and revoke privileges to specified directories in Novell. We noted that some of these users were given administrative access to manage storage capacity when needed. However, administrative rights are not required to perform this function.

Recommendation—Novell administrators have the ability to alter network parameters, which changes the manner in which the system operates. Administrators can grant, revoke or alter user access privileges, which can give users access to system functions outside of their normal usage. This could potentially shut down or delete data from the network rendering it ineffective and resulting in financial and/or operational damage, loss of system, or improper use of resources.

We recommend that CalPERS IT management review the current list of Novell Administrative users and revoke access to those who do not require it to perform their job functions.

Management’s Response

Information Technology Services Branch concurs with Deloitte's Information Security - Novell Administrators observation. The thirty eight (38) users identified in the audit with ‘administrative access’ in the system are limited to granting, revoking or altering user access privileges only to their respective directories and do not have system ‘root’ administrative privileges. CalPERS Centralized User Account Administration (CUAA), along with the Novell Administrator, reviewed the list of accounts with these ‘Supervisor’ privileges and revoked those accounts which did not require that level of access to perform their business function; reducing the number of accounts by 45%. Of the remaining 21 accounts, 14 (67%) are maintained within the Enterprise Desktop Customer Support team to respond to space and access issues. CUAA and the Novell Administrator will continue to monitor these accounts and review the list to ensure only authorized individuals are granted these privileges.

Item #11 – Information Security—Physical Access to Computer Rooms

Observation—In conjunction with our information security testing, we selected a sample of 10 employees with access to the computer rooms as of June 2005. From our sample of 10 users, we identified one user who was granted access to the computer room, although this access was not specified in the corresponding Access Request Form. In addition, there are currently 165 non Colliers employees who have access to the computer rooms, of which 146 are from ITSD. Frequent reviews of users with access to the computer room are currently not performed by CalPERS.

Recommendation—Inappropriate access to the computer rooms creates the risk of unintentional or intentional damage to information resources, including computer hardware, data storage media, and information systems documentation. If physical information resources are not adequately safeguarded, such resources may not be available when they are needed and/or recovery of such resources may be delayed in the event of an emergency.

We recommend that access to the computer rooms be granted only to IT staff requiring it as part of their job function. In addition, IT management should perform periodic reviews of employees with access to the computer rooms to determine if access is still appropriate.

Management's Response

Information Technology Services Branch concurs with this recommendation. In order to mitigate the risk of unintentional or intentional damage to information resources, including computer hardware, data storage media, and information systems documentation, the Data Center Section will implement a process to periodically review the access list, particularly of the Information Technology Services Branch (ITSB) staff with access to the computer room. Based on the review, appropriate actions will be taken to ensure computer room access by ITSB staff will be granted only to those requiring access as part of their job function.